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Celebrating Economic Weakness

"Speculations on the speculations of other speculators who are doing the same thing – those are bubbles."

Policies for Prosperity
James Tobin, 1987

We are told that after watching the hollow show put on by the G7 world leaders at their recent summit in Halifax, some of the journalists in attendance joked: "We've seen the seven dwarfs, but where is Snow White?"

We can understand the sentiment. Certainly, the summit's rhetoric about exchange-rate stability should be seen as mere fairy-tale wishes. While the threat of coordinated intervention may intimidate the markets for a time, we see no reason to believe the fundamental imbalances imperiling the dollar – and world financial markets – will be corrected by the G7's politicians. Accordingly, our expectation of a further, sharp dollar decline remains intact.

Indeed, we believe those bulls who speak so confidently of a new, golden age of global growth should ponder the seeming decrepitude of the West's political institutions. Is it plausible to expect an age of peace and prosperity when leadership of the world's most powerful industrial nations is in such feeble hands?

Looking at the current aggression against Bosnia, and the G7's shameless acquiescence in the most outrageous Serbian atrocities, we can only tremble to think what would have happened to Europe and the world if Adolf Hitler had been opposed not by Roosevelt, Churchill and de Gaulle, but rather by the likes of Bill Clinton, John Major, and François Mitterand. Once you make the comparison, you know how deep the Western nations have sunk.

Of course, none of this signifies on Wall Street, where the euphoric dreams of perpetual boom refuse to die, despite gathering evidence that the U.S. economy is sliding into the hard landing we predicted earlier this year. We can only watch with astonishment as each new sign of weakness is celebrated with another record high on the Dow. We couldn't imagine any clearer evidence of a speculative bubble in its final stages.

Yet we also think the bond bulls draw too much comfort from the looming recession. This may seem paradoxical, given the traditional correlation between a soft economy and a booming bond market. But, as we have explained in past letters, the United States now finds itself in the ugly position of any chronic debtor country that relies too heavily on short-term capital inflows. As signs of recession multiply, so do the risks of a dramatic flight from the dollar. This would leave the Fed with the little choice but to raise rates, or suffer the stagflationary consequences of a massive currency depreciation. Neither alternative can be considered constructive for bonds, to put it mildly.

In the final analysis, we think Wall Street places far too much faith in the Fed's ability to cure any and all financial ailments with a big dose of easy money. We find this complacency more than passing strange, given the Fed's present reliance on the charity of foreign central banks to ward off a wholesale dollar collapse.

In any case, we see no signs that Fed policy is, or has been, particularly tight. We think the fact that the U.S. economy nonetheless is tumbling into recession should be a source of deep alarm, not jubilation. But then, it is in the nature of bubbles to be irrational.

CREDIT IS PLENTIFUL

An outpouring of sluggish economic data has expelled any lingering doubts that the U.S. economy is receding both rapidly and sharply. While this is entirely in line with our expectations and forecasts, we must admit we are flabbergasted by the way Wall Street, though taken by surprise, instantly has celebrated this parade of weak economic numbers with unbridled euphoria by marching to one new all-time high after another.

It seems Wall Street never fails to make a bullish case out of whatever happens to the U.S. economy. Until recently, it was the consensus view that last year's sharp rise in interest rates couldn't hurt the stock market because its bull run was "earnings driven," underpinned by persistently strong GDP growth.

Faced suddenly with the opposite scenario of a sharp economic slowdown, essentially implying slower profit growth, if not an outright fall in profits, Wall Street instantly has changed its tune: Forget about profits, the bulls now say. The one and only factor that matters to the speculators is a booming bond market, soon to be followed by aggressive Fed easing. Armed with this reasoning, investors easily absorbed the shockingly bad May U.S. employment numbers, and quickly stoked the stock market into yet another boiling fury. Conveniently, the fact that business profits virtually have stalled since the second quarter of 1994 is widely ignored.

In the 1980s, the Wall Street bulls focused on yet another crystal ball to rationalize booming financial markets. The watchword at that time was "excess liquidity." This meant money growth in persistent excess of nominal GDP growth – and in fact, this trend was a hallmark of the era. Wall Street's happy conclusion: Surplus liquidity not needed in the real economy had nowhere to go but into financial assets, driving bond and stock prices higher.

We recall this episode because this time overall liquidity, as measured by the broad money aggregates, is falling dramatically short of nominal GDP growth. U.S. nominal GDP has grown 29% since 1989, while M3 growth barely has totalled 6% during that same period. By this measure, liquidity is tight as never before. Nobody cares. The market booms nevertheless.

But while money appears tight, credit is plentiful. Banks have been falling over themselves to extend credit to anybody willing to take it. That is why we strongly disagree with the consensus view that the U.S. economy's sudden slowdown is due to the Fed. There was not, and still is not, one iota of credit restraint imposed by the Fed.

In truth, the U.S. economy's sudden, sharp weakening actually has contrasted with sharply higher credit expansion. In the first quarter of 1995, nonfinancial debt growth accelerated to a 6.3% annual pace, or $816 billion, from 4.8%, or $595 billion, during 1994. While government and business borrowing shot up, the consumer retrenched. Considering that consumer credit had skyrocketed from a mere $5.5 billion in 1992 to $150 billion in late 1994, it was more than naive of forecasters to expect more of the same.

When, earlier this year, we first called for a hard landing of the U.S. economy – that is, an outright recession – in the course of this year, we based this forecast on the simple consideration that the ongoing consumer borrowing and spending spree, as well as the boom in inventory investment, simply were unsustainable. The great American consumer has to retrench from his excesses of last year.

Wall Street is the only astonishing part of the story. Though the economic data are proving much worse than generally expected, Wall Street is quick to conclude that bad news really is the very best news for the financial markets. A slowing economy, it is now widely preached, should spell both lower inflation and easier money – both being notorious harbingers of booming bond and stock prices. And so the markets rise. We can always trust Wall Street's ability to translate any news, however bad, into bullish news. In truly Orwellian fashion, old rules and theories of market behavior simply are rewritten overnight.

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (June 28)	Month	YTD	Y-Y	Vs 12-Mo Hi	Vs 12-Mo Lo
Australia	1.3%	7.2%	3.8%	-3.4%	12.4%
Canada	2.3%	7.5%	12.4%	-0.7%	13.5%
France	-2.8%	-0.8%	-3.7%	-11.9%	8.3%
Germany	0.9%	-0.5%	2.5%	-1.6%	9.7%
Hong Kong	-1.9%	11.7%	5.9%	-10.0%	31.3%
Japan	-6.9%	-26.6%	-29.3%	-29.9%	0.1%
Mexico	10.9%	-8.5%	-4.3%	-23.9%	50.2%
Spain	4.8%	4.8%	-0.1%	-6.8%	12.9%
U.K.	-0.9%	7.1%	11.4%	-3.6%	12.8%
U.S.	4.0%	18.6%	21.7%	-1.2%	22.6%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (June 28)	Current Rate (%)	Month	YTD	Y-Y	Vs 12-Mo Hi	Vs 12-Mo Lo
Australia	8.88	5	-112	-89	-184	25
Canada	7.80	-24	-135	-154	-188	12
France	7.53	7	-74	15	-90	35
Germany	6.80	10	-82	-19	-96	31
Japan	2.79	-25	-179	-161	-217	3
Spain	11.74	39	-9	132	3	159
U.K.	8.43	50	-28	-5	-59	75
U.S.	6.08	-31	-174	-115	-195	6

Exchange Rates
Versus U.S. Dollar, % Change

Country (June 28)	Current Rate	Month	YTD	Y-Y	Vs 12-Mo Hi	Vs 12-Mo Lo
Australia ($)	1.40	-0.5%	-8.1%	-0.9%	-8.6%	0.2%
Canada ($)	1.38	-0.3%	1.9%	0.7%	-2.5%	3.4%
France (*f*)	4.89	-0.8%	8.3%	9.6%	-2.7%	10.5%
Germany (DM)	1.40	-1.3%	9.9%	11.5%	-3.3%	12.6%
Japan (¥)	85.6	-3.2%	14.1%	14.5%	-6.1%	15.7%
Spain (Pt)	122.5	-2.2%	6.9%	5.8%	-2.2%	8.7%
U.K. (£)	1.58	-1.7%	0.7%	1.5%	-3.9%	3.3%

But what about the truth? Is a slowing economy good or bad for the stock market? Historical experience says it is bad. For more than 100 years, it has been characteristic that stock prices lead the business cycle, rising during economic recovery, and declining when the economy slows down.

Precisely for that reason, stock prices were chosen as a component of the U.S. index of leading indicators. On average, their lead over the economy is around five to six months, but there are wide variations. Exceptions to this rule are rare. The most famous was in 1929. While the business cycle peaked in June of that year, U.S. stocks peaked in September.

In recalling this traditional correspondence between stock prices and the business cycle, we wish to point out the uttermost abnormality of the present coincidence of a slumping economy with a booming stock market. What makes the situation even more mysterious is the fact that the overall ratio of the money stock to national income or GDP is in a steep decline, approaching postwar lows. Are the old rules once and for all obsolete? What has changed?

While we see a variety of reasons for the stock market's present odd bullishness, we would stress three key factors:

- Continued complacency about the economy's ability to touch down in a soft landing, and the implications for corporate profits.
- A universal tendency towards short-term momentum trading chasing quick returns.
- Heavy stock purchases by corporations in the wake of soaring mergers, acquisitions and buy-back programs.

The all-important question at this point is of course the economy's future performance. Will the steep descent visible in recent economic reports end in a soft or a hard landing? If a hard one, how hard? Is the United States now looking at the "mild, near-term recession" cited by Mr. Greenspan, or is something a good deal worse looming on the horizon?

Though the sharpness of the economic decline has shocked many economists, most of them continue to express their confidence that the economic slowdown should stop short of recession and rebound before the end of the year. The standard reasoning in support of this widespread view is that the usual precursors of recession, such as economic and financial excesses and imbalances, inflation and a credit crunch, are not in evidence this time.

What's more, these policymakers and economists feel reassured by several current developments:

- The strong rallies in bonds and stocks, involving sharp declines in medium- and long-term interest rates and big wealth effects. It is assumed that these alone are enough to restimulate the economy.
- The export-enhancing weakness of the dollar.
- The declared intention of U.S. businesses to continue their capital investment spending.
- The fact that business inventories, though they have surged recently, remain lean by historic standards.
- Eager and aggressive bank lending.

In light of these perceived strengths, Mr. Greenspan, among others, sees at worst a mild inventory recession.

COMPUTERS DON'T MAKE A LOCOMOTIVE

Sticking strictly to the facts, we observe that the U.S. economy's sudden slowdown has developed on a broad front, reflecting pronounced weakness in three major components of final demand: consumer spending, foreign trade, and government spending.

Inventories, far from being run down, have soared, growing in the first quarter of 1995 at a substantial $52.3 billion annual rate (in 1987 dollars). That's not quite as much as previously estimated, but still it is a near record. The only real strength at the level of final demand is in business equipment. Last year, it accounted for no less than 37% of real U.S. GDP growth.

Given this apparent, extraordinary capital spending boom, it is widely assumed that it will be sustained under the pressure of global competition. This will continue to lift productivity, and effectively counter any tendency towards an economic hard landing.

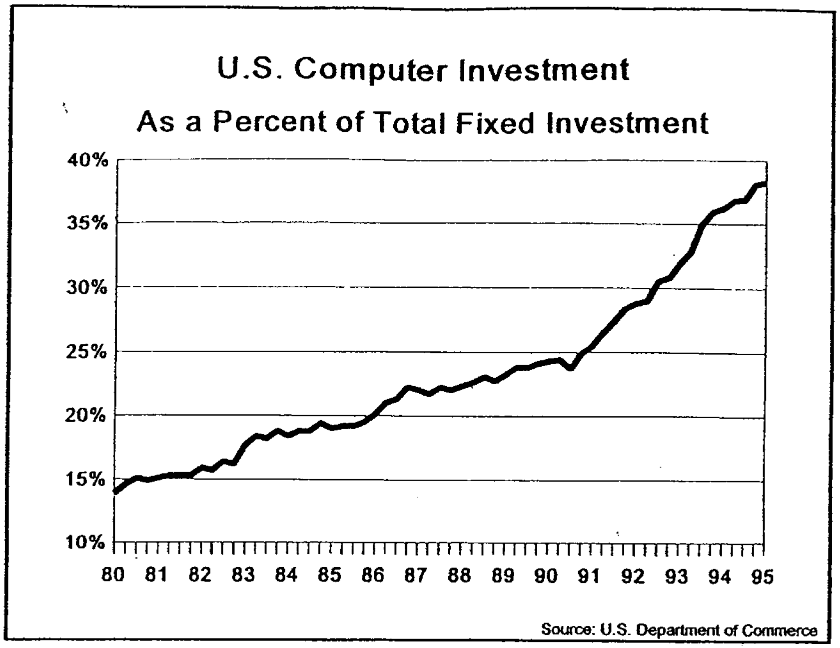
But in trying to assess the impact of investment on the economy, it is necessary to distinguish between two separate effects, namely, short-term demand effects and long-term supply and productivity effects. In the short run, while houses are being built and capital goods produced, current investment spending adds importantly to employment, wages and total effective demand – well-known in economic literature as the so-called multiplier effect. In the long run, once the houses and capital goods are completed, they add to the economy's capital stock and productive capacity – the supply effect of investment.

In pondering the probability of a U.S. recession, the point at issue is whether or not the current investment boom has sufficient power to pull the flagging economy forward again, forestalling a recession. After careful consideration, our answer is no.

This assessment has one main reason: the fact that spending on computers and other information technology accounts for the lion's share of the U.S. capital spending boom. The salient point is that this computer investment completely lacks the multiplier effects on effective demand, employment and income necessary to produce an "investment-led" recovery.

First of all, a disproportionate share of the computer equipment purchased by U.S. industry is imported from abroad. Secondly, the domestic production of computers involves a minimal input of labor and materials. Consider this: Last year, computers accounted for 23% of U.S. real GDP growth, but only 1.7% of U.S. industrial production. Actually,

more than 50% of computer investment since 1987 reflects a steep fall in equipment prices, which the statisticians at the Commerce Department reckon as real GDP growth in their calculations of the national income and product accounts.



In terms of investment multiplier effects, at the opposite extreme is building, which involves a high input of labor and materials and an extensive demand for the products of other industries. Strong construction therefore is the essence of a strong recovery. But in the United States, both residential and commercial construction are presently dead in the water.

For this and other reasons, we believe the U.S. economy is not poised for a rebound. Indeed, the truly critical part of the current economic slowdown hasn't even started yet, because inventories have continued to rise. The true recession will begin when businesses effectively reduce their inventories. This is bound to happen sooner or later, and it will turn the expected rebound into a slump. Preventing this inventory correction would require a strong increase in final demand, which we don't see.

THE PRODUCTIVITY MIRAGE

By nature, inventory corrections are violent but brief. What apparently haunts U.S. policymakers and economists is the risk that the adjustment process will set off a vicious downward spiral, in which output cuts lead to payroll cuts, which in turn lead to falling consumer incomes and spending, causing a further decline in investment, and so on. That is what we presently happening see in Japan, and also what happened in the United States in 1929-30.

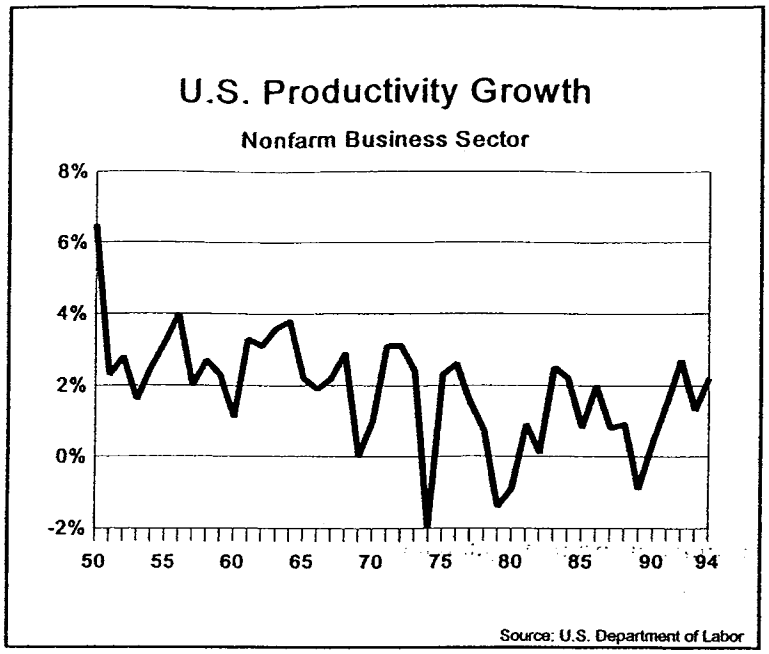
A propos, America's productivity revolution. It seems to us that Wall Street's gleeful reports about a U.S. productivity miracle from restructuring, downsizing and computerization have contributed importantly to the public's unending bullishness towards the financial markets.

Being aware that productivity gains over the current economic expansion have been no better than in past cyclical upturns, we have never quite understood this euphoria. Annual average gains of 2.1% during the first 15 quarters of this recovery compare with 2.2% recorded over the same period of preceding cyclical recoveries.

From recent testimony before a congressional committee by Mr. Stephen Roach, of Morgan Stanley, we lately have learned the real kicker here. Roach points out that the crucial difference between this cycle and past cycles lies in the fact that the recent productivity gains occurred in the context of decidedly weaker GDP growth than in the past (3.1% in the current cycle versus a norm of 4.4% in past cycles).

We are not sure this reasoning makes any sense. But in any case, we think it is already outmoded, as both the Commerce and Labor departments have given notice of impending revisions in GDP growth and employment during the 1990s, revisions that essentially demolish the idea of any secular revolution in U.S. productivity. For its part, the Labor Department has announced that the monthly payroll employment figures for the period from January 1994

to February 1995 have been revised upward by amounts of between 486,000 and 789,000 jobs. The Commerce Department, meanwhile, has decided that the current practice of measuring computer output in 1987 prices increasingly overstates the real value of current computer production. To correct this distortion, it has developed a new methodology and a new price index, both to be published later in the year. Preliminary results are said to show lower GDP in the 1990s.



Together, these two revisions – higher employment and lower GDP growth – make a shambles of any miraculous improvement in U.S. productivity growth. The impressive 1993-94 surge in corporate profits, widely attributed to the productivity miracle, can be seen for what it was: the result of a ruthless effort to cut labor costs by holding down wage growth and slashing employment benefits. While this campaign has succeeded in limiting the total growth in unit labor costs to a bare 12% over the past four years, we do not see that this has laid the foundation for a sustainable U.S. economic recovery.

Just the opposite, in fact. With wage growth stagnant, U.S. consumption growth must rely ever more heavily on rampant household borrowing, and a concomitant fall in the personal savings rate. But with the savings rate now far below any historic norm, and consumer debt burdens at an all-time high relative to income, we see little room for further expansion on that front.

We can only wonder what will happen once the U.S. economy slips into recession. In a typical slump, the economy's sharp cyclical downswing is cushioned by a falling savings rate, as households seek to maintain their customary consumption levels despite a sharp drop in personal income. But with the savings rate already near rock bottom, households well may resist any further decline. In such a scenario, consumption would fall in line with income, creating a downward economic spiral that could prove difficult to break. Fiscal stimulus – the usual remedy for such a development – may not come to the rescue, if we assume the U.S. politicians really are serious this time about balancing the federal budget.

WHERE IS THE MONEY COMING FROM?

Turning from the ailing economy to the flourishing financial markets, we read virtually nothing but bullish reports and commentaries. But it strikes us that none of the bulls addresses the key question: Where are the torrents of money required to push stock and bond prices still higher going to come from?

At issue is the question of whether or not the strong, recent rally in bonds and stocks is driven by positive "fundamentals," luring investors, or whether it is just another short-term speculative mania or bubble that sooner or later will burst.

In the consensus view, this new bull run in the financial markets fully is justified by a weakening economy and forthcoming monetary easing from the Fed. Apparently, those two factors are regarded as the decisive fundamentals. To us, on the other hand, it's just more of Wall Street's crackpot theories. It used to be basic knowledge in

economics that the interest-rate levels of a country are determined by the relationship between credit expansion and available current savings. In fact, it is the explicit function of interest rates to equilibrate the two.

When credit flows are vastly in excess of new savings flows, this indicates that interest rates are much too low. During the first quarter of 1995, as already mentioned, U.S. credit growth sharply accelerated to an annual rate of $816 billion, as compared to an annualized $265 billion in personal savings. This left a tremendous savings gap that essentially was filled by massive monetary inflation, eagerly provided by the Fed.

In 1991-93, the strongest single inflationary influence in the financial markets were the commercial banks. During that period, their net bond purchases totalled $300 billion, or an average $100 billion a year. But in 1994, faced with soaring loan demand, the banks first stopped adding to their bond portfolios and even started to liquidate them later in the year. During the first half of 1995, bank loan expansion has been running at an annual rate of nearly $350 billion, after $181 billion in 1994.

No less remarkable is the fact that the banks have been funding their loan explosion overwhelmingly with "managed liabilities." While keeping interest rates on their large mass of customer deposits at abnormally low levels, they've borrowed instead in the Eurodollar market and domestically through the issuance of senior banks notes that are close substitutes for large certificates of deposit.

These funding sources have some unusual features in common. First, they are not counted in the money supply. But what really makes them attractive to the banks is that they are not subject to a deposit insurance premium of 27 basis points, or to reserve requirements. This lending explosion and its funding have made a farce of monetary tightening.

THE BOND BULLS RETURN

Looking at the roaring U.S. securities markets, we have all the time wondered where the money driving their frenzied rise has been coming from. For us, that's the clue for identifying a bubble.

During the fourth quarter of 1994 and the first quarter of 1995, the biggest net sellers of Treasuries were state and local government pension funds and domestic banks. Private households, meanwhile, sharply reduced their bond purchases. The biggest buyers were foreign central banks, foreign banks in the United States, foreign investors and U.S. dealers and brokers. All in all, it makes for a strange mixture of bears and bulls. We wonder to what extent the so-called foreign investors actually were camouflaged foreign-based U.S. speculators operating with money borrowed in the Euromarkets.

In order to understand what actually happened in the markets, it has to be remembered that until February there had been an overriding expectation that unfettered economic strength would compel the Fed to further raise rates. Its last move, from 5.5% to 6%, was only in February.

The true speculative frenzy broke loose in the second quarter, when rapidly weakening economic data took the markets completely by surprise, creating an abrupt turn towards rampant bullishness. Chasing short-term gains in bonds, speculators flooded the market with borrowed and leveraged money. Virtually by definition, that constitutes a bubble, because the bulk of the buying is not "for keeps," but rather for dumping once further capital gains appear unlikely.

In these markets, clearly, short-term speculation dominates. Obviously, the derivatives and futures markets have immensely facilitated and stimulated speculation by offering ready, prodigious leverage. By the same token, the markets respond with unprecedented speed to any change in perceptions.

In past letters, we specifically have pointed to the dynamic effects of mortgage-fund hedging on the U.S. Treasury market. At some $1.4 trillion, the market for mortgage-backed securities is now about 30% larger than private holdings of Treasury securities of up to 10 years. It has been estimated that from October 1993 to April 1994, mortgage hedging by dealers, portfolio managers and investors equalled the sale of over $300 billion in 10-year Treasuries. The important point to see here is that at times trading in futures completely dominates the trend in cash prices, and that this trading is completely unrelated to economic fundamentals.

All trading in these markets is aimed at profiting from fluctuations in the prices of derivatives or hedging against changes in the prices of underlying assets. But the pertinent question is to what extent this trading influences or even determines prices in the cash markets. In other words, how much of the new boom in bonds and stocks has been manufactured in the leveraged futures and derivatives markets? We suspect a large part of it, if not most of it.

The connection between the derivatives and cash markets varies, depending on trends in speculation. The more diversified its trends, the looser this connection. But it becomes very tight when the speculation in specific assets runs overwhelmingly in one direction. Then, speculators in options or other derivatives wishing to take advantage of the prevailing trend – long, currently – must find a market maker willing to take a short counter position.

But in order to avoid losses on these unwanted short positions, market makers in options usually try to create matching long positions in the underlying assets. These are called delta (neutral) hedges. Indeed, they are neutral for the option dealer, but not neutral for the cash market. In such situations, the speculative activity in derivatives is prone to drive the cash market with tremendous leverage.

Further fueling the speculative frenzy is the current obsession of institutional investors with matching or exceeding various performance benchmarks, such as the total return on the various U.S. government bond indexes. The regular publication of their short-term performance forces them to jump on the band wagon of any speculative wave, even if they disagree with the premises and assessments driving the move.

1993 ALL OVER AGAIN?

In our view, all of this goes a long way to explain the rapid plunge in U.S. medium- and long-term interest rates. As soon as the threat of higher short-term interest rates receded earlier this year, the bond speculators were immediately back in full force, betting a looming recession would drive the Fed to slash rates and thus justify their positions. Reckless speculation may drive interest rates lower still, but the speculator as well as the long-term investor should realize that this is another bubble, not as enormous as in 1993, but a bubble nonetheless, and thus destined to burst.

We have no idea when the speculators will begin to unwind their positions, nor what might be the catalyst for such an event. Last year, the pin popping the balloon was the Fed's first tiny rate hike. This time, the outlook is for rate cuts. But if the dollar remains chronically weak, we can imagine a scenario in which the Fed would disappoint the expectations of large and quick cuts that are already factored into the yield curve.

Even a slight disappointment is apt to prick a bubble that by nature is extremely fragile. In 1993, leveraged speculators borrowed at a 3% short rate to buy intermediate Treasuries yielding 4% to 5%; Today, they borrow at 6% to buy notes barely yielding 5.5%. This so-called "negative carry" means that their speculative positions are money losers right from the start. Only a further big rise in bond prices, or an imminent Fed easing, will justify their bets. If disappointed, these speculators will not waste much time in bailing out of their losing positions.

What about the exuberant U.S. stock market? Does that rank as a bubble in our eyes? In the first place, as we said earlier, from a historical perspective it definitely is abnormal for stocks to boom in the face of a sharply weaker

economy. We think it is time to be alert to profit disappointments. The writing already is on the wall. In recent weeks, whenever a company has warned that coming profits would not match the analysts' bloated forecasts, its stock has been battered.

Who, then, is the big bull in the U.S. stock market? The cliché answer is that this bull run is driven by individual investors buying through mutual funds. But this is no longer true. Since the third quarter of 1994, such buying largely has been offset by the sale of directly owned stocks held by individual investors. In terms of net buying, the true Big Bull is none other than the corporations themselves. Merger and acquisition activities are running high again, and at the same time it seems to have become a common policy of corporate managers to boost their share prices by buy-backs and buy-back announcements. In 1994, such announcements hit a new record of $65 billion, according to Securities Data, although completions of those deals are very much lagging.

How to judge such a grossly distorted market? If the economy slumps, corporations may well step up their buy-backs. Still, we think that the market is highly vulnerable to a hard landing of the economy, which would batter high-riding profit expectations.

From the financial markets, we turn back to macroeconomics. Basic to our critical assessment of the dollar and the U.S. financial markets is the vast excess of credit and money flows over available domestic savings. By this gauge, there is rampant credit and money inflation, but it goes mostly into the trade deficit, into capital outflows and into the booming financial markets.

In this light, U.S. interest rates appear absurdly low. Given the large, chronic U.S. external deficit, this normally would imply a free fall of the dollar, which in turn would force the Fed to tighten its monetary reins in earnest. But so far, the massive dollar buying of the foreign central banks has spared the Fed of any need to defend the dollar.

In its just-published annual report, the Bank for International Settlements in Basle points out that total official dollar reserves rose last year by no less than $91 billion, to $679 billion. Just imagine what would have happened to the dollar and the U.S. financial markets without these huge interventions by foreign central banks. The dollar definitely would have gone into free fall all around, considering that its widely praised trade-weighted stability resulted mainly from the interventions of central banks in Asia and Latin America. In light of these facts, any talk of dollar strength appears to us as farcical. Any such strength is artificial, provided solely by foreign central banks. In the end, it is their support of the dollar that permits the Fed's monetary looseness, the same looseness that fuels the boom in the financial markets and perpetuates the huge U.S. external imbalance.

JAPAN ON THE BRINK

The other big headache facing the world economy and world financial markets is, of course, the escalating financial meltdown in Japan. Is Japan on the brink of a 1930s-style deflationary bust? The process that links Japan's current dilemma to the United States in the early 1930s is Irving Fisher's model of debt deflation.

In this model, excessive borrowing inflates the prices of assets, which then serve as collateral for more and more borrowing, inflating asset prices higher and higher. When the bubble eventually bursts, a general attempt to reduce debt defeats itself, because the stampede to sell underlying assets depresses their value, increasing the burden of fixed-value debt. In extreme cases, asset values fall faster than outstanding debt. The resulting collapse of credit and money can lead to outright price deflation, with disastrous effects on corporate profitability and investment.

To quote Fisher: "The very effort of individuals or institutions to lessen their burden of debts increases it, because of the mass effect of the stampede to liquidate is swelling each dollar owed." That's what happened in the 1930s in the United States, and that is what we see happening in Japan.

Japan: Financial Surplus or Deficit By Sector

As a percent of nominal GDP

Sector	1965-74 (average)	1975-84 (average)	1985-89 (average)	1989	1990	1991	1992	1993
Corporate Business	-7.1%	-2.9%	-3.5%	-6.8%	-9.1%	-6.9%	-6.0%	-3.2%
Personal Sector	9.3%	10.2%	8.8%	9.2%	9.8%	8.5%	10.2%	10.3%
Private Sector, Net	2.2%	7.3%	5.3%	2.4%	0.8%	1.6%	4.2%	7.1%
Public Sector	-2.6%	-7.1%	-1.5%	0.6%	0.8%	0.7%	-1.6%	-3.6%
Central Government	0.6%	-3.8%	-0.7%	0.4%	0.6%	1.3%	0.3%	-0.9%
Other	-3.2%	-3.3%	-0.8%	0.2%	0.2%	-0.7%	-2.0%	-2.7%
Domestic Net Balance	-0.4%	0.2%	3.8%	3.0%	1.6%	2.2%	2.6%	3.5%
Financial Sector	1.1%	0.6%	-0.6%	-1.0%	-0.4%	-0.1%	0.7%	-0.3%
Overseas Sector	-0.7%	-0.8%	-3.2%	-2.0%	-1.2%	-2.2%	-3.2%	-3.1%

Source: The Bank of Japan

Basically, Japan's present crisis is rooted in the excesses and distortions of the preceding credit-and-asset boom. This was unique not only in sheer scale, it also fueled two other bubbles in the real economy. One was a bubble in business investment, the other a consumer borrowing and spending spree on durable goods. At the height of the late 1980s boom, fixed business investment soared as high as 20% of GDP, as against a long-term trend of 15%. Just as the financial and real-estate bubbles interacted on the upside, they now interact on the downside. Their legacy is the need for savage balance-sheet and stock adjustments.

Most of the focus has been on the vicissitudes of the banks and other financial institutions, which are faced with nonperforming loans of a size that is apt to cripple their capital base and lending capacity. Japan's Ministry of Finance recently admitted that the banks still have some ¥40 trillion in problem loans – equal to about $500 billion, or nearly 10% of Japan's GDP. Even that probably isn't the full truth. It compares with the $200 billion the U.S. government spent on the bailout of the S&Ls.

As if that were not enough, the devastating loan problems of the banks are compounded by losses on their share holdings. Under an agreement with the Bank for International Settlements, Japanese banks are permitted to count 45% of the unrealized gains on their equity portfolios as capital. At present depressed stock prices, the capital ratios of most banks are just above the BIS minima. Any further decline in stock prices would eliminate that remaining slim margin. As a result, the ability of the banks to lend would shrink faster, damaging further the prospects for a healthy recovery.

For several reasons, it has proven extremely difficult for Japan to repair this mess. So far, the idea of a taxpayer-financed bailout has received a very hostile reception from the Japanese public, which regards the banks as the chief culprit for the excesses that have led to the present crisis.

Waiting for time and growth to heal the banking system's wounds also isn't feasible: Given Japan's low interest rates, the spread between bank deposit costs and returns on assets is at best half of what U.S. banks enjoy. Meanwhile, the banking crisis depresses the economy, which is in the throes of its own savage adjustment crisis.

While the financial meltdown is the most spectacular part of the crisis in Japan, there is more to it than that. Associated with the asset-price bubble were huge distortions and maladjustments in the real economy. When the bubble burst, it devastated capital values all around. The bad loans of the banks reflect this destruction of the capital values shown on the balance sheets of firms and consumers. All must labor under this burden. Essentially, businesses and consumers have been forced to slash spending, depressing the economy.

The table on the previous page gives an informative picture of what really happened to Japan's economy during and after the bubble years. The key point is that during the bubble years of 1989-91, the financing gap of the corporate sector – that is, the excess of capital expenditures over internal funds – surged to 9.1% of GDP. Yet, because this investment boom was more than matched by private savings and a small budget surplus in the public sector, there remained a domestic net savings surplus, which translated into a corresponding current-account surplus.

Likewise, the table reveals the root cause of Japan's current-account surplus, which has persisted despite a sharp swing in the public budget position from surplus to deficit. The chief reason is that the corporate sector has slashed its investment spending, reflected in a steep decline in its financial gap from 9.1% to 3.2% of GDP. Personal savings, meanwhile, have risen. As a result, the private sector taken as a whole ended up with a steeply increasing savings surplus, soaring from 0.8% of GDP in 1998 to 7.1% in 1993. This has more than offset the massive public deficit spending. The end effect: a chronic external surplus.

We don't see any meaningful improvement in this dismal picture. Reducing the export surplus would require a domestic spending spree, either on business investment, construction or consumption. This isn't in sight, or even conceivable. Business investment continues to slide. Given a discount rate of 1%, three-month deposit rates at 1.34%, and a long-term bond yield of barely 3%, the Bank of Japan clearly is "pushing on a string," just like the U.S. Fed in the early 1930s.

Foreign observers tend to accuse the Bank of Japan of grossly failing to boost liquidity, thus accounting for the rising yen and Japan's weak economic recovery. American economists, in particular, like to believe central banks can simply "print money." It is true central banks are the ultimate creators of credit and money, but they can only act on the economy through the banking system. What central banks truly control are bank reserves and the money-market rate. In the last analysis, effective monetary policy depends on the willingness of the commercial banks to translate it into credit expansion. In Japan's case, monetary easing is thwarted by insolvent banks.

THE YEN'S RISE WILL CONTINUE

The chief concern of the international investor is, of course, the implications of Japan's financial meltdown for the yen's exchange rate, in particular against the dollar. We note two opposite notions. One says that a double-dip recession will force the Bank of Japan to flood the economy with liquidity, which will partly flow overseas in search of lower yields, driving the yen downward. The contrarian view holds that Japan's persistent, large export surplus and hesitant capital outflows will maintain the upward pressure on the yen.

We side with the latter camp. What we see in Japan is an ongoing deflationary spiral that the Bank of Japan simply is unable to reverse in the near term. Under these circumstances, capital repatriations are far more probable than capital outflows. In fact, if not for the BOJ's persistent interventions, the dollar already would be a lot lower.

On the other hand, we see increasing monetary looseness on the part of the Fed. Hopes for a dollar recovery rest on the assumption that a weaker economy will curb the U.S. trade deficit. But as the world economy is anything but robust, we see very little potential for trade improvement. Meanwhile, lower short-term rates and a slumping economy are bound to curb the huge short-term capital inflows. Monetary easing, in fact, has never failed to depress the dollar. We see no reason why this historical truth should falter now.

CONCLUSIONS

The powerful U.S. stock and bond rallies have all the markings of speculative bubbles. This is hardly a new trend. It is never possible to say in advance where or when a bubble will reach its peak, or what will trigger its inevitable collapse. But we think very little upward potential is left.

At this point, investors face two overriding questions. One is the severity of the U.S. hard landing. The other is the dollar's inherent strength or weakness. We are not sure if the recession will be brief or protracted. But recent trends in U.S. income growth, along with staggering consumer debt burdens, create the ominous potential for a self-feeding downward spiral.

Regarding the dollar, we note that the usual, optimistic forecasts once again abound. The greenback, we are told, finally has found its bottom. We, on the other hand, see only reasons why it should continue to fall. The long-term negative – the huge U.S. current-account deficit – will not improve unless and until the U.S. economy falls deeply into recession. But that will bring a new short-term negative: sharply lower U.S. short-term interest rates.

Recently it has become fashionable among the dollar bulls to argue that short-term interest rate differentials no longer matter for the greenback. They cite as proof the obvious fact that while the Fed raised rates in 1994, the dollar nevertheless weakened. From this, they conclude that because higher rates did not help the dollar then, a shift to Fed easing will not hurt it now.

Let us dispose of this notion simply by noting that since the birth of the modern floating exchange-rate system in the early 1970s, Fed easing moves almost invariably have been associated with a weak dollar. The sole significant exception to this rule came in the mid-1980s, at the height of the dollar bubble. That episode, it may be remembered, ended in a near dollar free fall.

In short, we think it more logical to assume that since Fed tightening failed to prop up the dollar last year, Fed easing now would send it plummeting. But the extremely speculative nature of the private "hot money" flows now supporting the dollar makes it impossible to predict exactly how the market will react to the Fed's first rate cut. That test is likely to come soon.

We suspect that in the end, only the continued, aggressive support of foreign central banks can prevent a dollar free fall. This they may be willing to do, at least for a time. But we do not think it wise to count on their perpetual support. We can only repeat our long-standing advice: Seek safety and liquidity by diversifying into the cash and short-term bonds of the hard-currency countries, primarily Germany, Switzerland, Austria and the Netherlands.

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